FINANCE AND ECONOMICS

Time to turn off the tap?

WASHINGTON, DC

Capital controls are becoming fashionable. Unfortunately, few people understand what they involve

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MUCH as fashion designers like to make a virtue of reinventing the past, politicians are increasingly thinking retro. With investors fleeing one emerging market after another, leaving shattered economies in their wake, a swelling chorus insists that capital controls, an idea as novel as the hoop skirt, were a sensible invention after all.

Mahathir Mohamad, Malaysia's mercurial prime minister, has just imposed them, and many of his counterparts are giving them a serious look. As an alternative to desperation, capital controls have acquired a certain cachet: there seems no other quick way to stabilise currencies, cut interest rates and strengthen stockmarkets. But their allure may be deceptive. The term "capital controls" takes in a huge variety of policies—most of them undesirable.

Strictly defined, capital controls include only restrictions that affect the capital account of a country's balance of payments. That takes in limits on foreign investment in financial markets, on direct investment by foreigners in businesses or property, and on domestic residents' investments abroad. Capital controls are not, on this definition, the same as "exchange controls". Capital controls restrict asset movements, while exchange controls can also affect spending on imports and the use of foreign currency earned from exports.

Both types of controls were much in fashion before and after the second world war. Restrictions on the use of foreign currency for trade had vanished in most rich countries by the early 1960s. By 1997, according to the International Monetary Fund, over 140 countries had made their currencies convertible for such purposes.

Capital controls, in contrast, have remained far more widespread. After the second world war, only Switzerland, Canada and the United States adopted open capital regimes. Other rich countries maintained strict controls; many, indeed, stiffened them during the 1960s and 1970s. Those were the days when you had to get your passport stamped to receive foreign-currency notes, and when British tourists in France took along their own food to save on precious francs. Driven partly by technical innovation that rendered such controls increasingly ineffective, and partly by a growing vogue for free markets, most advanced economies dismantled the controls in the 1980s and early 1990s.

In developing countries, however, the trend has been less uniform. Latin American countries had relatively few controls during the 1960s; they imposed manifold restrictions during the debt crisis of the 1980s to build up foreign-currency reserves; and then took them off rapidly from the late 1980s. Asian countries began to loosen capital controls in the 1980s, a trend that accelerated in the 1990s. The IMF's figures show that in 1997 144 countries still had controls on foreign direct investment, and that 128 regulated international financial-market transactions in some way. Nonetheless, the unmistakable trend has been towards fewer capital controls.

The reasons for this are both ideological and practical. Ever more countries have realised that foreign capital is a vital resource for financing domestic investment. It has helped pay for motorways in Mexico, telecoms systems in Argentina, mines in Indonesia. This capital inflow has been accompanied by infusions of technology and know-how that have helped many emerging economies grow faster.

Governments have also learnt that capital controls do not work well and can have undesirable consequences. Latin America's controls in the 1980s did little to keep money at home but a lot to deter foreign investment. Controls helped to feed corruption, as bureaucrats were empowered to determine who would be exempted from them. And as governments have gradually liberalised domestic financial markets, restricting access to foreign markets has seemed increasingly anachronistic.

Bubble trouble

So why the clamour for new controls? Because free capital mobility involves risks as well as opportunities. Rapid inflows, for instance, can complicate monetary policy. They can lead to excessive lending and to bubbles in equity and property markets. Rapid outflows, as much of the emerging world is now discovering, make it harder to reduce interest rates to stimulate domestic economies. Flows into bank deposits are particularly dangerous: capital can arrive or flee remarkably quickly, leaving policymakers no time to react. Hence the sense that something must be done to control such flows.

Few of today's advocates of capital restrictions would like to see an end to the broader process of financial and economic liberalisation. Instead, most hope that controls on short-term capital flows might make them less volatile. Almost always, they mean controls on inflows. Chile is widely cited as a model. It has various restrictions on inflows, including a requirement that a portion of any money borrowed abroad be deposited for a year at the central bank, without interest. However, economists disagree about the effectiveness of Chile's short-term capital controls.

Prudential controls on capital inflows certainly make sense, particularly when domestic banks are weak. Indeed the distinction between capital controls and sensible bank regulation can become blurred. But not all inflow controls are like this. South Korea, for instance, lifted restrictions on short-term inflows in the early 1990s but kept limits on long-term investment. This contributed to banks' and industrial companies' over-reliance on short-term foreign loans, which could no longer be serviced after the currency collapsed last October.

At present, however, most debate about controlling capital inflows is beside the point. The big concern in emerging economies is capital outflows, as investors sell domestic currency and take the proceeds abroad. If controls on outflows could deter capital flight, goes the thinking, central banks could lower interest rates and revive their economies.

There are several ways to control capital outflows. The mildest approach taxes the purchase of foreign assets. This might discourage investment abroad in normal times, but it will not stop capital flight in a crisis. That requires stronger measures. Malaysia (see article) now restricts foreigners from converting the proceeds of Malaysian securities into dollars unless they have held them for a year. It also limits the use of ringgit outside the country. Other countries use dual exchange rates to the same end, making it more expensive to acquire foreign exchange for the purpose of investing abroad.

This is not as easy as it sounds. Controls on capital outflows are harder to enforce than controls on inflows, since investors have a far bigger incentive to find ways round them. For the same reason they tend to be far more draconian. And even if the controls are explicitly designed to exclude foreign direct investment, as are Malaysia's, history suggests investors shy away nonetheless. So even if controls on capital outflows can buy time in a short-term panic, it is time bought at a high longer-term price.

Ironically, perhaps, the price is higher and the benefits lower the more a country is integrated into world financial markets. For the more sophisticated the instruments investors have at their disposal, the less likely controls are to work. It is also hard for any country that has dismantled its bureaucratic machinery for administering capital controls to reintroduce them quickly.

These practical difficulties, let alone the dangerous side-effects, have received little attention in the renewed debate over capital controls. Just as it took the return of stiletto heels to remind people how absurdly uncomfortable they were, so it may take the re-emergence of controls to remind policymakers of their drawbacks. Unfortunately the price of misguided policies will be rather higher than sore feet.